June 2024

Emerging Market Debt Indicator

The fast view

Market background

Improving inflation dynamics in the US ultimately boosted global fixed income markets, but developments within emerging markets drove up volatility and weighed on some currencies. This resulted in a negative return in the local currency EM bond market, in contrast with the gains seen in sovereign and corporate hard currency debt markets.

Africa

Egypt reached a staff-level agreement with the IMF on a potential disbursement. The IMF also increased the scale of its programme with Zambia in response to drought in the country. Reflecting positive reform momentum, the World Bank approved a US$2.2 billion loan for Nigeria, and Moody's upgraded the country's credit outlook to positive.

Asia

The market responded well to several cabinet appointments by India's newly sworn-in Prime Minister Narendra Modi. A strong tech sector remained supportive for the South Korean economy, and China continued to benefit from exports of solar panels and electric vehicles, although Chinese economic activity remains lacklustre overall. Interest rates were kept on hold in much of the region but easing inflation pressure in the Philippines brought forward the prospect of rate cuts.

Latin America

A pause (or slower pace) in rate-cutting reflected a more hawkish tone among the region's central banks. Mexico's election result delivered a much stronger-than-expected performance by the incumbent Morena party. Concerns around the potential for this to lead to constitutional changes prompted the peso to sell-off, which then spread to other regional currency markets.

Central and Eastern Europe, Middle East, and South Africa

South Africa's election result drove up market volatility, with the ANC failing to win an outright victory. Volatility ensued before the prospect of a market-friendly outcome boosted domestic assets, with the agreement of a Government of National Unity. In CEE, lower-than-expected inflation prints marked a reversal of recent months and rate cuts continued in Czechia and Hungary. Despite tight financial conditions in Turkey, growth has held up well and consumer confidence is strong.

EM corporate debt highlights

The positive effects from the fall in US Treasury yields and healthy carry offset a negative impact from a slight widening of credit spreads. Both the high-yield and investment-grade parts of the market generated similar total returns and all sectors and countries delivered positive returns, led by the real estate sector in the former and issuers in Chile in the latter.

Werner Gey van Pittius
Co-head of Fixed Income

Market background

June was a volatile month for fixed income markets. In the middle of the month, US Treasury yields fell across the yield curve following the release of lower-than-expected US inflation figures, with other developed government bond markets following suit. Towards the end of June, higher-than-expected inflation data from Canada and Australia drove a partial reversal of this and weighed on investor sentiment, although the US 10-year Treasury yield still ended the month 10bps lower at 4.40%.

Against this backdrop, EM debt market performance was mixed. The local bond market (JP Morgan GBI-EM GD) returned -1.1% over June, driven entirely by EM currency weakness (-1.9%), while the hedged local bond market returned +0.8%. EMFX was impacted by the unwinding of carry trades in Latin America over the month (relating to the Mexican election result). In the hard currency space, the sovereign debt market (JP Morgan EMBI GD) rose 0.6%, driven by the investment-grade segment of the market, which benefited from the fall in US Treasury yields. The corporate debt market (JP Morgan CEMBI BD) also generated a positive total return, gaining 0.9%, with both high-yield and investment-grade market segments adding to returns.

Top-down views and outlook

Top-down positioning at the end of June 2024

	- -	-	0	+	+ +
Overall risk				■	
Hard currency debt			■		
Local rates				■	
FX			■		

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From a top-down perspective, we continue to have a positive overall risk target. While US economic growth surprises have been softening (albeit from a high level), growth in emerging market (EM) economies has generally been surprising to the upside, resulting in an evening out of global economic growth. We retain a neutral top-down risk exposure in EM hard currency debt and EM FX as we think the backdrop of ongoing US Treasury market volatility (as developed-market inflation remains sticky) is more conducive for earning carry and implementing bottom-up relative-value trades than for taking top-down views. In EM hard currency debt, we prefer to focus selectively on bottom-up opportunities and are rotating some credit exposure from high-yield to investment-grade markets in reflection of valuations, following recent market moves and to avoid positioning vulnerabilities. We remain overweight local rates as inflation in EM economies continues to print lower than consensus expectations, although we acknowledge some diverging trends between services and goods price inflation. We still believe select markets offer attractive real rates, and rate-cutting cycles have further to go in some EM economies.

Outlook

Recent data releases have continued to lead markets to become more confident of a 'soft landing' (rather than a recession) for economies, especially the US. Despite inflation falling in the US, messaging from the Federal Reserve leant on the hawkish side in June, with the median dot plot forecasting just one full cut in 2024, as resilient economic growth means the outlook for rates remains uncertain. The market continues to price in the first US interest rate cut for later this year, but further rate-market volatility could materialise if the eventual pace at which the Fed unwinds its tight monetary policy undershoots expectations.

While financial markets are likely to remain volatile, we continue to be constructive on the medium-term outlook for returns from the EM debt asset class. Many EM economies have solid fundamental foundations. The more fragile economies are receiving plenty of support from the IMF and other multilaterals. Furthermore, with much of the painful interest-rate hiking now behind them, many EM economies are in an enviable position relative to developed markets overall, with most EM central banks either having completed their hiking cycle or beginning to cut rates. EM bond market valuations look attractive – with some markets still pricing in significantly more risk than we believe is justified.

Regional highlights

Africa

The central bank in **Egypt** kept rates on hold in June as the Egyptian pound appears to have stabilised and inflation is starting to fall. The government reached a staff-level agreement with the IMF, which should result in a disbursement of c.US$820 million on approval by the IMF's board. Heat waves have resulted in power outages due to higher demand for air conditioning and this is likely to put pressure on trade balance given the need for gas imports. This weighed on the country's hard currency bonds. However, financial account inflows from a large real estate deal with the UAE are providing a helpful counterbalance.

In **Kenya**, following the deadly protests towards the end of June against a proposed finance bill that would raise taxes, President Ruto said the government will plug the US$2.3 billion financing gap with spending cuts instead of tax hikes. Earlier in the month, the IMF approved the seventh review of the Extended Fund Facility (EFF), but questions remain as to whether the spending cuts will be sufficient to meet the funding gap.

The IMF increased the scale of its programme with **Zambia** in response to the domestic drought and approved a US$570 million disbursement, helping the country's local bonds. From 11 June, the new restructured hard currency bonds began trading and Zambia is no longer in default status. JP Morgan has confirmed that the new bonds will be added to the flagship EM bond Index. GDP data for Q1 2024 showed a slowdown in growth given pressure relating to the drought and tight monetary policy. However, exports improved, helped by both copper prices and production.

The World Bank approved a US$2.2 billion loan for **Nigeria**, which should help to improve the country's reserves; the move also highlights the World Bank's positive view of the country's reforms. Moody's raised Nigeria's credit outlook to positive, suggesting that the country can achieve a B3 rating if it continues with its current policies (its current rating is Caa1 at Moody's). The central bank adopted a data-dependent approach as it moves towards inflation-targeting monetary policy.

The government in **Ghana** and the official creditor committee reached a preliminary deal on the country's external bond restricting. This helped Ghanaian hard currency bonds over the month. Inflation has been moving higher in the country due to passthrough from the weakness in the cedi.

In **Senegal**, issues around the fiscal deficit meant the IMF did not conclude the review of its programme; the deficit is likely to be higher than the IMF wants due to ongoing food and cement subsidies. This will delay the IMF's review, but we expect the path of consolidation to remain as the medium-term fiscal framework forecasts a fiscal deficit of 3% in 2025, which is a positive development and likely means the IMF programme should remain on track.

Asia

In **China**, data on economic activity, such as fixed-asset investments, property sales, and credit growth were all relatively subdued over the quarter. However, exports remained strong – helped by sales of solar panels and electric vehicles. China's authorities kept the medium-term lending facility (MLF) and the 1- and 5-year loan prime rates on hold, as expected. Regarding inflation, CPI remained low overall at 0.3% year-on-year and the producer price index (PPI) remained in deflationary territory, albeit by less than expected. Given the combination of weak inflation and lacklustre growth data, onshore government bond yields fell over the month. The renminbi depreciated, but only modestly, as the authorities allowed the currency to weaken slightly via the daily fixings. The government confirmed that the third plenum – an event that occurs every five years where the government typically sets out the country's structural economic plans – will take place in mid-July. However, market expectations around this meeting are low.

In **India**, Prime Minister Narendra Modi was sworn in following the National Democratic Alliance's victory in the elections. Modi has already appointed several cabinet members, which the market responded well to. The budget is set to be announced in July and will be a key focus for market participants. The larger-than-expected dividend from the Reserve Bank of India boosted government revenues, and last year's narrower fiscal deficit last year will also provide the government with some flexibility when setting the budget.

In **Indonesia**, comments from incoming President Prabowo that suggested he wants debt to rise from 30% to 50% of GDP over his tenure spooked investors and caused bond yields to spike. As the month progressed, the government walked back on the comments of fiscal slippage, which helped the bond market to recover somewhat. The central bank kept rates on hold as expected.

The central bank in the **Philippines** also kept rates on hold as expected and issued a dovish statement, suggesting that the chance of an August rate cut had increased given reduced inflation forecasts due to the lower import tariffs on rice.

There have been signs of increased political pressure in **South Korea** for the central bank to cut interest rates, although rates are expected to remain on hold for now, with inflation still above target. Strong demand for the country's tech sector continued to boost economic activity.

In **Taiwan**, the central bank kept interest rates on hold as expected, but it tightened both the reserve requirement ratio and mortgage lending criteria. Reflecting continued demand for semiconductors, industrial production data was strong.

Latin America

Central banks across Latin America turned more hawkish, with monetary policy setters in Brazil, Peru, and Mexico keeping rates on hold rather than making cuts. Despite this hawkish shift, currencies across Latin America weakened meaningfully as market participants began to unwind their carry trades, partly caused by the Mexican election-driven sell-off of the peso (outlined below).

Mexico's incumbent Morena party performed a lot better than expected in the country's elections to secure a 'super' (two-thirds) majority in the lower house and just short of this in the Senate. As this would allow the party to push through amendments to the constitution, the Mexican peso sold off sharply and other regional currencies followed suit. Towards the end of the month, President-elect Claudia Sheinbaum appointed some credible cabinet members; market participants welcomed this but eagerly await details of who will be chosen to run the state-owned oil company, Pemex.

Robust fiscal numbers continued to emerge from **Argentina**, thanks to the ongoing reform agenda. The omnibus reform bill was passed by the Senate and has now gone back into the lower house. Separately, the IMF approved the review of the current programme.

Monthly headline inflation in **Brazil** was higher than expected in May as floods put upward pressure on food prices, although preliminary numbers for June have shown some softening in the data. The Brazilian central bank board voted unanimously to keep rates on hold compared to the market's expectation for a rate cut. The meeting was taken as hawkish as one of the central bank's published alternative scenarios showed inflation falling back down to the bank's target levels if monetary authorities kept rates on hold in 2024 and 2025.

In **Chile**, the central bank cut rates by 25bps, reducing the pace of cuts from the previous month's 50bps. The overall messaging was also on the hawkish side, with inflation not expected to get back down to the bank's target until 2026. In addition, the government announced a large upward revision to administered electricity prices, which is likely to push up CPI inflation by over 1% over the coming months.

The government in **Peru** passed its pension reforms in Congress, which is market-positive overall as it contains a provision that prevents future pension fund withdrawals, although there will be some fiscal impact over the long term. The central bank kept rates on hold (consensus expectations were for a cut) as it adopts a more cautious approach.

In **Colombia**, congress passed President Petro's pension reform bill as expected – this is the first reform that Petro has managed to pass. The labour market reform is also making progress, which was more of a surprise, but it will likely get watered down. The government cut its spending plans by 1.5% due to weaker fiscal revenues; the market responded positively to this as it signals that the authorities plan to meet fiscal rule targets.

Poor weather in **Ecuador** has created a domestic electricity crisis. While drought prevailed in the first part of the year, heavy rain in June has impacted oil exports, leading to Petroecuador cutting exports.

Central and Eastern Europe, Middle East, and South Africa

Economic growth data remains relatively soft in Central and Eastern Europe (CEE), but ongoing strength in wage growth and benign inflation is supporting a recovery in domestic consumption.

Across the region, inflation prints were lower than expected – a correction from the higher-than-expected prints over the last few months. Central banks have continued to cut rates in **Czechia** and **Hungary**, but they are trying to sound hawkish for the second half of 2024 and are now on data-dependent pathways. Rate cuts may continue but will likely be at a slower pace, and central banks will be cognisant of the global macro backdrop and concerns that the battle against inflation is not fully complete. In **Poland**, inflation appears benign but the roll-off of energy price caps in July will push it back above the National Bank of Poland's (NBP's) target range. This is reinforcing the NBP's hawkish bias, and rate cuts are not expected until the middle of next year.

Turning to the rest of the region, inflation remains problematic in **Turkey**, but there are some tentative signs that momentum is beginning to moderate. This is being helped by the authorities' ongoing tight stance on credit conditions and monetary policy, which should lead to slower growth in the second half of 2024 and support disinflation. In addition, headline inflation is likely to have peaked due to base effects and should fall in the months ahead. Despite the tight financial conditions, growth has held up well and consumer confidence is strong.

In **South Africa**, the surprise election result at the end of May meant the ANC did not achieve an absolute majority for the first time since 1994. Although South African financial markets have been volatile, the agreement for an unprecedented Government of National Unity prompted a significant recovery in South African assets. Away from the elections, inflation was slightly higher than expected (both headline and core). Growth data was more mixed, with weaker retail sales but better manufacturing data.

Inflation in **Israel** was lower than expected and is now within the target band set by the central bank. However, the bank remains concerned about the geopolitical backdrop.

In **Ukraine**, the official creditor committee failed to reach a deal on the country's external debt restructuring. This was not a huge surprise given both sides are quite far apart, but they are trying to reach a deal ahead of the end of the agreed payment standstill period which may prove challenging given the tight timeframes.

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EM corporate debt highlights

The EM corporate debt market had a positive month from a total return perspective, with the JP Morgan CEMBI BD gaining 0.9%. The positive effects from the fall in US Treasury yields and healthy carry offset a negative impact from a slight widening of credit spreads. Both the high-yield and investment-grade components of the index generated similar total returns. Within the index, all sectors and countries delivered positive returns, led by the real estate sector in the former and issuers in Chile in the latter.

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